ASX announcement

21 November 2018

FIRST QUARTER TRADING UPDATE AND FY19 GUIDANCE

Smiles Inclusive Limited (ASX: **SIL**) provides the following trading update for the three months to 30 September 2018 and earnings guidance for FY19.

KEY POINTS

- Integration of initial portfolio of 52 practices fully completed, within 120 days of acquisition completion. Expenditure associated with acquisition and integration now complete, with approximately $1.6 million impact on Q1 statutory results.
- Q1 cash receipts of $11.6 million were below budget of $13.7 million as a result of integration issues and underperformance in a small minority of practices.
- Trading performance improving with average monthly daily revenue increasing by approximately 14% year to date.
- Lessons from integration of 52 practices have contributed to a robust methodology to reduce integration risks and costs and drive improved performance from future acquisitions.
- Acquisition of three Gold Coast practices completed 16 November. Consideration of $3.4 million at 5 times EBIT acquisition multiple, consistent with valuation of initial portfolio.
- Active acquisition pipeline representing $15 million in gross revenue, including $4 million in advanced negotiations.
- FY19 cash EBITDA is expected to be $5.0 million and NPAT of $2.3 million.

Trading performance

In its announcement of 31 October 2018, the company disclosed significant events at two practices which resulted in an impact of $(800,000) on Q1 revenue.

- Legal proceedings against a practice were not disclosed to the company by the vendor during the acquisition process, resulting in the closure of the practice and loss of revenue. Smiles has commenced legal action against the vendor and the practice is expected to re-open for patient bookings in February 2019.
- Smiles Inclusive was saddened by the sudden death in July 2018 of the lead practitioner and Joint Venture Partner in one of its Sydney practices. The practice was temporarily closed and locum dentists have now been engaged.

At the time of integration, Smiles did not have appropriate tools in place to manage unscheduled leave, which resulted in a $(600,000) impact on Q1 revenue. A tool has now been implemented to provide three-month rolling visibility of leave arrangements, and staff contract addendums have been put in place.

While trading in the majority of practices has met or exceeded expectations, 11 practices underperformed in the first quarter, with a $(700,000) impact on Q1 revenue. Localised marketing campaigns have commenced to improve performance.

The combination of these issues led to a shortfall of revenue against budget for the first quarter. Cash receipts for the quarter were $11.6 million compared with an expectation of $13.7 million.

Management actions to address these issues have begun to deliver an improvement in performance with average daily revenue across the portfolio increasing by more than 8% from $169,000 in July to $183,000 in October 2018, and a further $192,000 for November month-to-date.

Practice integration

Integration of the initial portfolio of 52 practices is now fully completed after the roll-out of the Totally Smiles branding across the network and commencement of national marketing campaigns. Expenditure associated with the acquisition and integration of the initial portfolio has been completed, with an impact of approximately $(1.6) million on statutory results for the quarter.

During the integration of the initial 52 acquisitions, a number of operational matters were identified and remedied through management actions. Insights from the integration and addressing these matters have contributed to a robust approach for future acquisitions, that will significantly reduce integration risks and costs, and drive improved practice performance.

The company has enhanced its systems for acquiring and integrating new practices to simplify the process for vendors. Contracts have been updated to provide more detailed transitional arrangements going forward. Enhanced support is provided to acquired practices with a business manager assigned from the date of settlement and additional practice management training. Rostering will be reviewed within 21 days of acquisition and Totally Smiles branding will be implemented within 90 days.

Managing Director, Mike Timoney said, “The focus on building a connected national network within our first 120 days has given us insights into the strengths and weaknesses of each practice, and identified important improvements to our integration approach.

“These lessons have strengthened the foundations of the business and will help us to drive performance improvement and streamline the integration of future acquisitions.

“The benefits of this approach are gathering momentum with average daily revenue increasing by 8% over the financial year to date and a number of organic growth initiatives being implemented.”

Organic growth initiatives

A number of organic growth initiatives are being implemented across the practice network to drive patient numbers and chair utilisation, including:

- Chair utilisation: Smiles acquired 167 chairs in the initial portfolio and engaged 93 practitioners. The number of practitioners has increased by 22% to 114 as part of a continued active focus on increasing utilisation of acquired chairs.
- Existing patients: Mining of existing databases at each practice commenced in October, to identify patients who are past 12 months since their last dental check-up. A call centre will be activated from December 2018 to contact these patients.
- Improved patient recall: Practice management training and streamlined patient reminder processes have been implemented across the network to increase the number of patients who book regular visits.
- Alternative payment channels: Zip Money and Afterpay have been activated in all practices and a national marketing campaign launched in November to promote alternative payment options.
- In-house referrals: An analysis of practitioner skills and services across the network has been completed and communication between practices has been improved, to increase referrals within

the network. This will enhance the patient experience and reduce the leakage of patient spend to external practices.

- Online campaigns: Localised and national online marketing campaigns to increase patient numbers commenced in November.

New acquisitions

Smiles has completed the acquisition of three Gold Coast dental practices under the Joint Venture Partner model for a consideration of $3.4 million. The practices were valued at 5 times EBIT, consistent with the valuation multiples for the initial portfolio.

The Joint Venture Partner model continues to attract interest from prospective vendors with an active pipeline of acquisition candidates equating to $15 million in gross practice revenue, $4 million of which is at advanced negotiations stage, plus a further $45 million in leads. The company has available funding capacity of $17.6 million for approximately $35 million in gross practice revenue.

FY19 earnings guidance

The company's trading performance is building momentum after the successful integration of the initial portfolio and the implementation of a range of organic growth initiatives, and average daily cash revenue per quarter is forecast to increase throughout the financial year as follows:

- Q1 - $178,000
- Q2 - $210,000
- Q3 - $230,000
- Q4 - $245,000.

The company expects corporate overheads of $1.1 million per quarter excluding acquisition and integration costs. Additional acquisition ($0.4 million) and integration ($0.2 million) costs are expected in the second quarter of the financial year, relating to the three acquisitions announced today.

The company expects FY19 EBITDA of $5.0 million (including integration and acquisitions costs to date of $2.2 million) and NPAT of $2.3 million. The guidance does not include the impact of future acquisitions and their associated costs.

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